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SIPDIS

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TREASURY FOR INTERNATIONAL AFFAIRS - JROSE

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TAGS: EFIN ENRG EPET TU
SUBJECT: Turkey's Energy Bill Adds to Current Account Deficit

ANKARA 00006380 001.2 OF 002

¶1. (SBU) Summary: Turkey imports well over 90% of the crude oil and natural gas it consumes, and imported natural gas -- from Russia and Iran -- accounts for 45% of electricity production. In addition to the concern this raises about supply security, high energy prices are a main factor adding to Turkey's sizeable and problematic current account deficit and sustaining inflationary pressures. The recent fall-back in oil prices brought welcome relief, but Turkey remains very exposed to exogenous factors, and is taking a number of steps to reduce reliance on high-cost imported energy. These include adding nuclear and renewable energy to diversify its energy mix, switching to lower cost suppliers, and increasing energy efficiency. End Summary.

High Energy Prices Drive Current Account Woes

¶2. (SBU) Dramatic price increases over the last two years have fueled an increase in Turkey's net imports of energy and gold from 5.5% of GDP in 2003 to 7.4% in 2006. According to a recent Morgan Stanley report, net fuel imports alone are estimated at 5.7% of GDP this year. Primarily due to increases in energy costs, Turkey's current account deficit ballooned from 4.4% of GDP in 2003 to over 7.5% in 2006. If energy costs had remained unchanged, the country's current account deficit would have narrowed -- not widened -- from the price-adjusted peak of 5.8% of GDP in 2004 to 4.2% in 2005 and 3.4% this year.

¶3. (SBU) Turkey's exposure as a significant net importer of energy and as a passive price taker reduces its control over its economy. The recent drop back in prices from the $79 peak to below $60 will clearly be fortuitous for Turkey's current account deficit, but the impact depends on how long prices stay at today's levels or lower. Moreover, if oil prices fall because of slowdown in global GDP growth, the impact on Turkey's exports could more than offset the windfall from lower energy prices.

...and is a Key Factor in Inflation

¶4. (SBU) The surge in energy prices is also a key factor in Turkey's other big macroeconomic headache -- stubbornly high inflation. Analysts estimate that every $10 per barrel change in world oil prices cause a one percentage point increase or decrease in Turkey's consumer price index, albeit with about a two-month lag. This means that high oil prices before the early August peak exacerbated the jump in inflation brought on by the May-June fall in the exchange rate. Now that prices have fallen by about $20 per barrel, the fall should help the Central Bank resume the disinflationary trend that prevailed from 2002 through the first quarter of 2006.

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Reducing Import Addiction - Changes in Energy Policy
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¶5. (SBU) According to the IEA's 2005 review of Turkey's energy policies, Turkey's use of energy per unit GDP (energy intensity) is low compared to OECD countries, but like developing countries in general, energy intensity continues to rise. This indicates that Turkey is using the energy it imports less efficiently than do other countries. Recent statistics indicate that energy intensity may be turning the corner and starting to decline, but this differs from the most current IEA projections that forecast continued increase in intensity through 2010.

¶6. (SBU) Turkey has made significant policy changes on both the supply and demand sides to improve the efficiency of energy use. The Minister of Energy announced the Government's intent to maximize use of indigenous energy for electricity production, targeting increased use of domestic coal (lignite) and hydropower. Unlike its neighbors, Turkey has limited hydrocarbon reserves and production. The GOT held out high hopes for BP/Chevron exploration in Turkey's eastern deep water Black Sea, but the results of drilling are uncertain. U.S. firm Toreador will soon start production of natural gas in a shallow off-shore area east of Istanbul. Turkey is in the process of passing a new Petroleum Law that would increase

incentives for foreign investment in oil and gas exploration and production in Turkey.

¶7. (SBU) The Turkish government has announced its decision to add nuclear power to its energy mix, but this is a long-term prospect at best given the large amounts of private investment that are required. Turkey has passed both new Renewable Energy and Energy Efficiency Laws, but incentives are still ambiguous or uncertain in time frame and application. Turkey recently opened its first commercial electricity wind farm near Bandirma in Western Turkey, but wind and other renewables remain a small part of its energy mix. Many of the changes in legislation and policy aim to move Turkey's approach more in line with that of the EU, which has identified specific targets for electricity generated from renewable energy.

¶8. (SBU) In addition to policies aimed to improve both demand and supply side aspects of its energy balance, Turkey aims to improve its energy security by augmenting supply source diversification. Turkey is highly dependent on Russia (67% for natural gas) and Iran (16% for natural gas), but these are high priced gas suppliers with reliability risk. Turkey's ample trade deficit with Russia (over $10 billion in 2005) is driven by purchases of $4.6 billion for oil and $3.6 billion for natural gas. Therefore, in order to seek lower cost supplies, Turkey is committed to gaining natural gas from Azerbaijan, Iraq, and Turkmenistan. Turkey is strongly interested in developing these sources for its own consumption, as well as transit to Europe.

Comment

¶9. (SBU) While the recent down-turn in oil prices is welcome (Economy Minister Ali Babacan announced that Turkey's projected energy imports for this year - $28-29 billion -- are now projected to fall back to $13.5 billion.), it underscores that Turkey as

significant net energy importer will retain a significant vulnerability to exogenous factors until it can improve its energy balance through both supply and demand policies.

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